Supreme Court, U.S.
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No. 96-1161

In The

Supreme Court of the United States

October Term, 1996

MOHAMMED SAMIH BARAKAT, an individual,

Petitioner,

v.

THE LIFE INSURANCE COMPANY OF VIRGINIA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether this Court should grant certiorari to determine if the debtor demonstrated a separate business or economic justification for separately classifying the mortgage deficiency claim of The Life Insurance Company of Virginia?

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

The Life Insurance Company of Virginia ("LICV") hereby opposes the Petition for Writ of Certiorari ("Petition") filed by Mohammed S. Barakat ("Barakat"), the debtor in the underlying chapter 11 bankruptcy case, and respectfully represents as follows:

I. STATEMENT OF THE CASE

Barakat's statement of the case is mostly accurate, with one key omission. Barakat fails to include in the Petition that the bankruptcy court found that he failed to demonstrate any reason for separately classifying LICV's mortgage deficiency claim as required by the binding decision of *In re Tucson Self-Storage, Inc.*, 166 B.R. 892 (Bankr. 9th Cir. 1994). The Debtor never offered any evidence of, and the bankruptcy court found that "[n]o such business justification exists in this case." [*See* Appendix attached to Barakat's Petition ("Appendix"), page A-66.]

II. THE DENIAL OF THE WRIT IS MANDATED

A. Introduction

Five circuit courts have held that a debtor must have a separate economic or business justification to separately classify a mortgage deficiency claim of a secured creditor in a plan of reorganization. These decisions are supported by sound policy, legislative intent, and the express language of the Bankruptcy Code. One circuit court has held otherwise. The anomalous decision of one circuit court

does not create a conflict between the circuits. The decision herein does not significantly affect chapter 11 bankruptcy cases. Additionally, recent amendments to the Bankruptcy Code resolve the issue and thus mandate denial of Barakat's Petition.

B. Summary of Argument

Barakat's Petition should be denied for several compelling reasons. First, the Petition does not present a significant issue of federal law, but rather only Barakat's failure to meet the factual requirements of the applicable standard of law. The Ninth Circuit's decision herein is plainly limited to the facts this case.

Second, the decision of the Seventh Circuit misinterprets both Sections 1122 and 1129 of the Bankruptcy Code[1] and thus there is no conflict between the circuit courts. Barakat incorrectly asserts that thousands of chapter 11 cases will be affected by the Ninth Circuit's decision. The issue decided in this case has limited application and thus does not present a significant federal question of law.

In addition to the Ninth Circuit's decision herein, the Second, Third, Fifth, and Eighth Circuits have uniformly held that it is impermissible to separately classify a Section 1111(b) deficiency claim of an undersecured creditor without an independent justification. *In re Boston Post Road Ltd. Partnership*, 21 F.3d 477 (2d Cir. 1994); *In re Greystone III Joint Venture*, 995 F.2d 1274 (5th Cir. 1991)

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[1] Title 11 of the United States Code. All references to sections are to the Bankruptcy Code unless otherwise stated.

(thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan); *In re Bryson Properties, XVIII*, 961 F.2d 496 (4th Cir. 1992); *In re Lumber Exchange Building Ltd. Partnership*, 968 F.2d 647 (8th Cir. 1992); *John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154 (3rd Cir. 1993).

Barakat contends that separate classification of a deficiency claim is mandatory pursuant to the Seventh Circuit's decision in *Matter of Woodbrook Associates*, 19 F.3d 312 (7th Cir. 1994). Barakat asserts and the Seventh Circuit holds the minority position which is not substantiated by the plain meaning of the applicable statutes, their legislative history, or policy considerations.

Finally, recent amendments to Section 1124 of the Bankruptcy Code have modified the definition of "impairment." As a result, debtors may now more easily create an "impaired consenting class" of administrative convenience claims to meet the requirements of Section 1129(a)(10), thus alleviating the need to separately classify mortgage deficiency claims. Accordingly, Barakat's Petition should be denied.

C. Barakat Failed to Offer Any Justification for Separately Classifying LICV's Deficiency Claim

Barakat failed to offer any evidence or justification for separately classifying LICV's deficiency claim and thus failed to meet the applicable standard of law. The bankruptcy court specifically found that "no such justification exists in this case." [Appendix, page 66.] Thus, the Ninth Circuit's decision is limited to the particular

facts of this case and does not present a question of federal law.

D. Barakat and the Seventh Circuit Misinterpret the Bankruptcy Code

Barakat improperly classified LICV's unsecured claim in contravention of Sections 1122 and 1129 of the Bankruptcy Code to gerrymander its general unsecured creditor class, without any evidence or offer of proof of an independent business or economic justification. Such gerrymandering is impermissible and in violation of Sections 1129(a) and 1129(b) because Barakat failed to offer or prove any separate business or economic justification for separate classification.

1. The Plain Meaning of Section 1122 Does Not Authorize the Unfettered Separate Classification of Deficiency Claims

Barakat follows the decision of the Seventh Circuit and argues that the plain meaning of Section 1122(a) allows debtors the unfettered right to separately classify similar claims. The Seventh Circuit and Barakat incorrectly interpret subsection (a) in a vacuum, ignoring other sections of the Bankruptcy Code. One must analyze the Bankruptcy Code as a whole, in order to properly understand particular sections.

> "Statutory construction, however, is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme – because the

> same terminology is used elsewhere in a context that makes its meaning clear."

United Savings Association v. Timbers of Inwood Forest, 484 U.S. 365, 371, 108 S.Ct. 626, 630, 98 L.Ed.2d 740 (1988).

Section 1122 provides the general guidelines for the classification of claims as follows:

> "(a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.
>
> (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience."

Barakat's interpretation ignores subsection (b) of Section 1122, as well as other sections of the Bankruptcy Code such as Section 1111(b). Section 1122(b) provides authority for the separate classification of claims for the sake of administrative convenience, i.e., claims of small amounts. If subsection (a) allows a debtor to separately classify similar claims, then subsection (b) would be unnecessary altogether.

> "A fair reading of both subsections suggests that ordinarily 'substantially similar claims,' those which share common priority and rights against the debtor's estate, should be placed in the same class."

Greystone III, 948 F.2d at 139. The Fifth Circuit in *Greystone III* concluded that:

> "if § 1122(a) permits classification of 'substantially similar' claims in different classes, such classification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims."

Id. at 139.

Additionally, one cannot analyze Section 1122(a) without acknowledging Section 1111, which provides in relevant part that:

> "(b)(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claims had recourse against the debtor on account of such claim, whether or not such holder has such recourse unless –
>
> (i) the class of which such claims is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; . . .
>
> (2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed."

Section 1111(b)(2) would be meaningless if Section 1122(a) is interpreted to allow for the separate classification of a secured creditor's deficiency claim. *Greystone III*, 948 F.2d at 140. Section 1111(b)(2) allows an undersecured secured creditor to choose the treatment of its claim. The creditor may choose not to make the election, thus bifurcating the creditor's claim into a secured claim in the amount of the value of the collateral, and an unsecured

claim for the deficiency. This provides the creditor with a lower secured claim, thus lower payments on the secured claim over the life of the plan, while allowing the secured creditor to vote as a general unsecured creditor in the amount of its deficiency claim.

The secured creditor may elect treatment under Section 1111(b)(2), thus requiring that the entire claim be treated as secured in the plan of reorganization even though the value of the collateral is less than the claim amount. This would provide the secured creditor with a higher secured claim under the plan of reorganization, thus higher payments on this claim over the life of the plan, but the creditor would not be able to vote along with the general unsecured creditors. The election under Section 1111(b)(2) to bifurcate would have no meaning or purpose since separate classification of the deficiency claim would effectively disenfranchise the creditor's unsecured claim and prevent that unsecured claim from having any voice with other unsecured creditors.

2. Other Bankruptcy Code Sections Do Not Permit Unfettered Classification

Barakat's reading of Section 1122 also violates Section 1129(a), the section governing the elements which must be shown for confirmation and Section 1129(b), the section governing "cramdown" over a non-consenting class. By allowing separate classification of unsecured claims without any justification, a debtor could literally separately classify every single creditor, until at least one vote is found in favor of the plan, and thus obtaining the "accepting class" required by Section 1129(a)(10). Such a

modest threshold would make a mockery of the (b)(1) cramdown requirement which, among other things, requires that the plan "not discriminate unfairly." The "balance of power" between the plan proponent, usually the debtor, and the estate's creditors would be tilted out of balance and the vote of any non-consenting class or classes, irrespective of number or size, is held hostage to the plan proponent's cramdown effort. Any notion of democracy or majority rule which underlies the reorganization process is severely compromised.

Barakat's interpretation of Section 1122 also mocks Section 1126(c) which defines an accepting class as one in which at least two-thirds in amount and more than half in number have accepted. There would be no need for the percentages of Section 1126(c) if the plan proponent could simply separately classify every creditor, ensuring a 100% vote in each class. Such a twisted interpretation has been rightly rejected by the majority of other circuits, as discussed below.

E. The Majority Rule of the Circuit Courts

The Second, Third, Fifth, Eighth, and now Ninth Circuits have held that it is impermissible to separately classify a Section 1111(b) deficiency claim of an undersecured creditor without an independent justification. *Boston Post Road*, 21 F.3d 477; *Greystone III*, 995 F.2d 1274; *Lumber Exchange*, 968 F.2d 647; *Bryson Properties*, 961 F.2d 496; *John Hancock Mut. Life Ins. Co.*, 987 F.2d 154. All of these cases have held that it is improper to separately classify the deficiency claim of a secured creditor from

the general unsecured creditor class based upon the creditor's right to make an election pursuant to Section 1111(b)(2).

In *Boston Post Road*, the chapter 11 debtor sought confirmation of a plan of reorganization in which the debtor had separately classified the secured creditor's deficiency claim, as well as the claims of tenants for residential security deposits. The Second Circuit held that the unsecured claim of a secured creditor should have been placed in the same class with the other general unsecured creditors and that the residential security deposits were not impaired within the meaning of Section 1124(1). *Boston Post Road*, 21 F.3d at 479. Specifically, the Court held that:

> "The other circuits have generally held that separate classification of similar claims is permissible only upon proof of a legitimate reason for separate classification, and that separate classification to gerrymander an affirmative vote is impermissible."

Boston Post Road, 21 F.3d at 481, citing to *Greystone III*, 995 F.2d at 1279.

The Court further held that:

> "Separate classification of unsecured claims solely to create an impaired assenting class will not be permitted; the debtor must adduce credible proof of a legitimate reason for separate classification of similar claims."

Boston Post Road, 21 F.3d at 483.

The Second and Fifth Circuit decisions in *Boston Post Road* and *Greystone III* are based upon the legislative history of Sections 1111(b) and 1122.

> "Moreover, a reading of Section 1122 in the context of the rest of the Code suggests that discretionary separate classification of similar claims would undermine the Section 1111(b) election. As explained above, Section 1111(b) of the Bankruptcy Code permits an undersecured creditor to choose whether (i) its claim should be divided into a secured claim equal to the court-determined value of the collateral and an unsecured claim for the deficiency, or (ii) its entire claim should be considered secured. **The purpose of the Section 1111(b) election is to allow the undersecured creditor to weigh in its vote with the votes of the other unsecured creditors. Allowing the unsecured trade creditors to constitute their own class would effectively nullify the option that Congress provided to undersecured creditors to vote their deficiency as unsecured debt."**

Boston Post Road, 21 F.3d at 483 [emphasis added].

The Eighth Circuit has also held that it is improper to separately classify the deficiency claim of an unsecured creditor.

> " . . . [S]eparate classification of [the creditor's deficiency] claim eliminates a significant benefit of electing recourse status under 11 U.S.C. § 1111(b) – [the creditor's] opportunity to vote for or against confirmation as a member of the class of unsecured creditors."

Lumber Exchange, 968 F.2d at 649-50, citing to *Greystone III*, 948 F.2d at 140.

Barakat's Petition should be denied in light of the strong majority rule propounded by five of the six circuits which have ruled on the issue. The Seventh Circuit's decision in *Woodbrook* is an anomaly and is not a basis for granting the Petition in this case.

F. The Majority Position Is Supported by Sound Policy

The decisions of the Second, Third, Fifth, Eighth, and Ninth Circuits have created a flexible judicial rule which allows for separate classification of a deficiency claim when a court finds there is a legitimate independent business or economic justification for such separate classification. Barakat argues that these cases create a rigid rule that one may never separately classify a deficiency claim, thereby "creating bad law" in operating cases that should be legally confirmable. That is simply not true.

As discussed herein, these cases afford courts the flexibility to determine whether there is a legitimate and independent justification for separate classification beyond the need to gerrymander the classes to obtain a consenting impaired class, as there often is in legitimate operating cases. Barakat contends that there are other options such as the arguments that one could make upon confirmation hearing, motions to appoint a trustee, or other kinds of extraordinary relief. These remedies do not provide any solution to the problem created by debtors' gerrymandering of classes.

The reality is that in single-asset real estate bankruptcy cases, the secured creditor is frequently the one holding the largest claim. In this case LICV holds most of

the debt by a vast majority, even if one were to compare LICV's claim to the unsecured debt plus the value of the equity shareholders. There is nothing inappropriate about LICV having a significant voice in the outcome of a reorganization in order to make it meaningful. The goal of bankruptcy is to benefit not just Barakat, but his creditors. The extreme position taken by Barakat would preclude the bankruptcy court from ever having the ability to exercise discretion to protect a claimant's interests, as Congress intended and as the Bankruptcy Code provides.

In the case at hand, Barakat *never* offered *any* evidence of an independent justification for separate classification of LICV's deficiency claim. Barakat's separate classification of LICV's deficiency claim was improper due to the lack of a legitimate independent business or economic justification pursuant to the binding law of *Tucson Self-Storage*, 166 B.R. 892. Accordingly, the bankruptcy court correctly held that Barakat's plan impermissibly classified LICV's deficiency claim.

G. Other Lower Court Decisions Follow Majority Rule

Lower courts in the Ninth Circuit and other circuits have recently followed the decisions of the Second, Third, Fifth, and Eighth Circuits, thus demonstrating the general consensus that it is not permissible to separately classify a deficiency claim without an independent justification. The bankruptcy court recently emphasized that most courts attempt to find an independent justification for separate classification other than the need for an impaired consenting class.

> "Most courts have looked to see if there is some business or economic reason independent of the debtor's need to separately classify the deficiency claim in order to confirm its plan."

See In re Baldwin Park Towne Center, Inc., 171 B.R. 375, 376 (Bankr. C.D. Cal. 1994), citing to *Boston Post Road*, 21 F.3d at 483; *In re Johnston*, 21 F.3d 323, 328 (9th Cir. 1994); *Tucson Self-Storage*, 166 B.R. at 898; and *In re Moorpark*, 161 B.R. 254, 257 (Bankr. C.D. Cal. 1993).

The district court in New York denied confirmation of a plan and granted relief from the automatic stay based upon the debtor's separate classification of the secured creditor's unsecured claim in order to prevent the secured creditor from dominating the general unsecured class. The district court upheld the bankruptcy court's decision and found that confirmation was not possible due to the improper gerrymandering of the classes. *In re One Times Square Associates, Ltd. Partnership*, 165 B.R. 773 (Bankr. S.D.N.Y. 1994).

The court in *One Times Square* specifically recognized that there was no rational basis for separately classifying the unsecured claim of the secured creditor.

> "The bankruptcy court's conclusion that the Plan could not be confirmed under the cram-down provisions rested primarily on its finding that the Debtor's proposed classification scheme was an impermissible attempt to manipulate the vote." *One Times Square*, 165 B.R. at 775.

See also In re North Washington Center Ltd. Partnership, 165 B.R. 805 (Bankr. D. Md. 1994) (held that it was impermissible to separately classify the trade creditors from the unsecured claim of the secured creditor); *In re Cantonwood*

Assoc. Ltd. Partnership, 138 B.R. 648 (Bankr. D. Mass. 1992) (holding that bankruptcy court has eliminated legal distinction between nonrecourse deficiency claims and other secured claims); *In re 266 Washington Associates*, 141 B.R. 275 (Bankr. E.D.N.Y. 1992) (courts concluded that the Section 1111(b) artificial deficiency claim of an undersecured creditor could not be separately classified).

H. Recent Bankruptcy Code Amendments Resolve the Issues

The Bankruptcy Reform Act of 1994 ("Reform Act") resolved the issues in this appeal and thus Barakat's Petition should be denied simply on this basis alone. The Reform Act deleted Section 1124(3) of the Bankruptcy Code, thus modifying the definition of "impairment." The primary issue in this case is whether a mortgage deficiency claim can be separately classified from other unsecured creditors so that a debtor may more easily obtain one impaired consenting class of creditors as required for plan confirmation pursuant to Section 1129(a)(10). Under the Reform Act a debtor may now obtain an impaired consenting class of administrative convenience claims, and thus need not separately classify a mortgage deficiency claim in order to obtain the one impaired consenting class needed to confirm a plan of reorganization.

1. The Amendment to Section 1124

Before the Reform Act, Section 1124 provided as follows:

"Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan –

(1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; or

(2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default –

(A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title;

(B) reinstates the maturity of such claim or interest as such maturity existed before such default;

(C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law; and

(D) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest; or

(3) provides that, on the effective date of the plan, the holder of such claim or interest receives, on account of such claim or interest, cash equal to –

> **(A) with respect to a claim, the allowed amount of such claim . . . "** [Emphasis added.]

2. The Amended Code Allows the Easy Creation of an Impaired Consenting Class

The Reform Act eradicated Section 1124(3) which deleted from the definition of "impaired" any creditor who was paid in full.[2] A debtor may use Section 1124 in conjunction with Section 1122(b) to create a class of administrative convenience claims which will be paid in full. As a result, a debtor may now, for example, separately classify administrative convenience claims in a separate class and provide for their full payment. Such a class is now "impaired" pursuant to Section 1124, and would consent to a plan which provides for their full payment. Thus a debtor could easily obtain the "impaired consenting class" requirement pursuant to Section 1129(a)(10) and would no longer need to classify a mortgage deficiency claim separately from the other general unsecured creditors.

I. Granting Certiorari Would Result in Unreasonable Delay to LICV

LICV will suffer substantial actual harm if the Petition is granted because the underlying property may be

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[2] The Bankruptcy Reform Act applies to cases filed after October 22, 1994. Barakat's case was filed before that date and thus the amendments do not apply to his case.

tied up for at least an additional one to two years. Obviously, the loss of use of the property in LICV's lending business for an extended period of time represents a substantial hardship to LICV. LICV will lose the opportunity to recapture its investment and may suffer a loss of its investment should the property continue to decline in value. LICV has already lost the opportunity costs of its investment while the property has been tied up in the pending appeal. Accordingly, LICV would be substantially harmed by the granting of the Petition and thus Barakat's request should be denied.

Moreover, the granting of the Petition in this case would also prevent LICV from exercising its rights pursuant to loan documents to which Barakat agreed. The stay in effect during the appeals process chills future investment incentives to lending institutions similar to LICV. As set forth above, Barakat filed the Petition as a delay and leverage tactic and, therefore, Barakat's Petition must be denied.

III. CONCLUSION

The Second, Third, Fifth, Eighth, and now Ninth Circuit decisions and their progeny are all squarely on point with the case at hand. The bankruptcy court found that Barakat separately classified the undersecured portion of LICV's claim from the general unsecured class without *any* rational basis or legitimate business or economic justification. By separately classifying LICV's claim, Barakat hoped to create an impaired class which would vote to accept its plan of reorganization. If LICV's claim had not been separately classified, LICV would

have dominated the unsecured class, and Barakat would not have had a consenting impaired class as required by Sections 1129(a)(10) and 1129(b). Barakat's separate classification of LICV's unsecured claim is impermissible, and thus the bankruptcy court properly granted LICV's motion for relief from the automatic stay.

The Seventh Circuit Court of Appeals decision in *Woodbrook* is an aberrational decision. The Seventh Circuit concluded that it was permissible to separately classify an unsecured deficiency claim which arises by operation of Section 1111(b) from other general unsecured claims. That Court determined that separate treatment is allowed solely on the distinction that the claim is created by operation of law.

The Second, Third, Fifth, Eighth and Ninth Circuits have held that such a distinction, without more, is insufficient to justify separate classification. All of the circuits are consistent that special circumstances must exist for separate classification. The Seventh Circuit merely found that a deficiency claim created by law supplies such a justification. However, this distinction alone does not present a substantial federal question that must be resolved to create national uniformity.

The argument that this case will have any kind of significant effect on chapter 11 cases generally is unsound. Many economic and business justifications exist which would facilitate confirmation of a debtor's plan in most situations. Barakat never even articulated a reason for the separate classification of the deficiency claim. This case is confined to its facts and is extremely unlikely to

reoccur. Thus no significant issues of federal law exists. In addition, the Reform Act now allows debtors to easily create an impaired consenting class, thus alleviating the need for separate classification of a mortgage deficiency claim.

For the foregoing reasons, Barakat's Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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